DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15196
San Diego, California

40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

December 14, 1966 Letter 343

THE MARKET: The first primary (downward) leg of the bear market started on February 9 at 995.15, and ended in March at 911.08. A correction then took the Dow to an April peak of 954.73. The March-April correction "looked good," and most observers stayed bullish on the trend of the market.

The second primary leg took the Dow from the April high of 954.73 to a May low of 864.14. This decline "ruffled Wall Street's feathers," but the rally back to a June high of 903.22 served to calm frayed nerves. The majority of investors continued to believe that the great bull market was still intact.

The third primary leg carried to an August low of 767.03, and at this point panic began to creep into the market. Many accounts were being subject to margin calls, a large number of leading blue-chips were down 20% to 40% from their highs, and the speculative high-flyers of 1965 and early 1966 (Xerox, Fairchild, SCM, Motorola, etc.) had, in many cases, been cut in half. The phrase "bear market" was beginning to be heard across the land.

Following a little rally to 814.30(September), the market turned down again and the Dow smashed to a low of 744.32. By this time the bear thesis was not only becoming accepted, it was becoming fashionable. The heaviest odd-lot short totals in history were appearing, news of the market's cave-in was making the newspaper headlines, analysts who were bullish at the top and most of the way down were finally throwing in the sponge.

When things look too easy on Wall Street, it's time for a "fooler." The 1966 fooler started at the October low of 744.32. Here, the market reversed to the upside, and within a period of 8 weeks, Industrials retraced 30% of all the ground lost between February and October. From the 820.87 recovery peak of November 16, the market backed off again, this time declining to a low just under 790.

From there the latest rally began. The "job" of the new rally will be to try to take the Dow above the November 16 high (820.87), and thereby to raise hopes all along Wall Street. There is obviously still a great deal of distribution to be done, and it would not surprise me to see many high-volume days (7 to 10 million shares) between now and the end of the year, with much "churning," group rotation, erratic action, and froth. The net result could be a move by the Industrial Average into the 840-870 range (870 marks the halfway level of the entire February to October collapse).

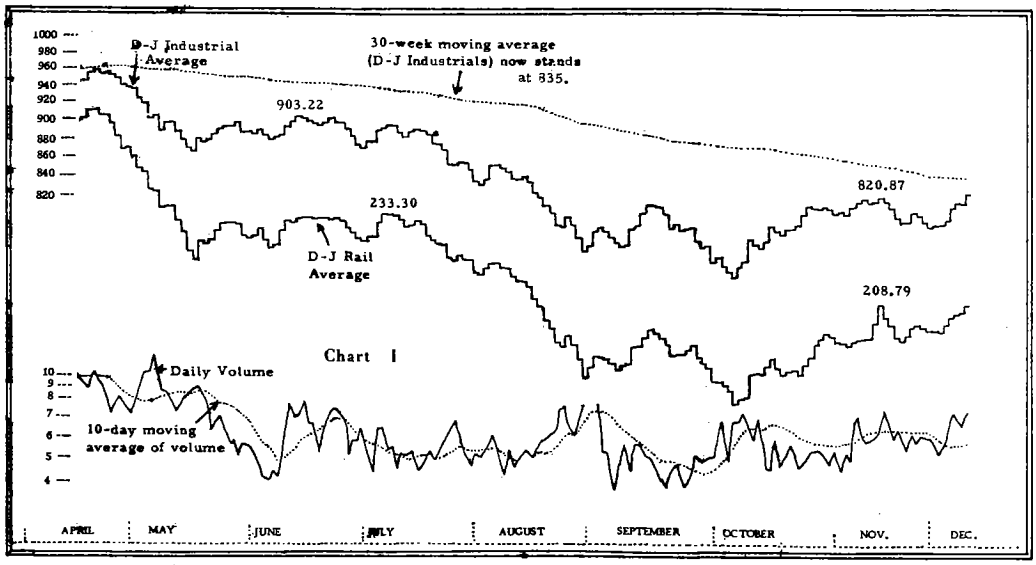
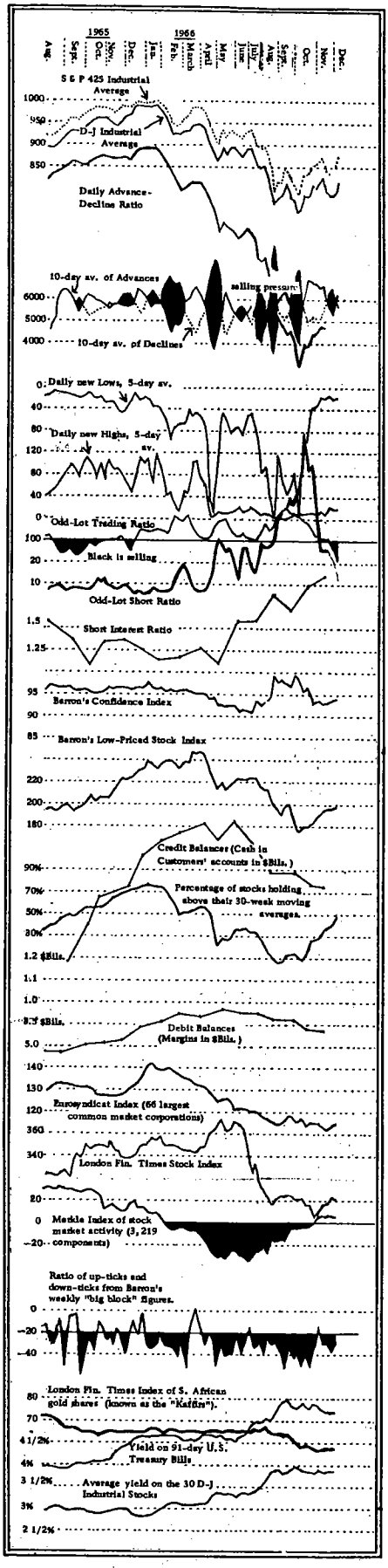


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Euroyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

The best exercise for subscribers at this time would be to study charts covering a large number of N.Y.S.E. issues. You will be amazed at how few stocks are rallying back anywhere near their highs of the past year or so. The remarkable thing, as a matter of fact, is how many stocks are holding just above their 1966 lows. It is also the quality of the stocks which are holding near their lows which is disturbing. For example, over the last 10 days such blue-chips as Allied Chemical, Commercial Credit, General Motors, Union Carbide and Woolworth all recorded new 1966 lows. This is hardly a bullish performance, and I feel it is hinting of danger for the market during the first quarter of 1967

FUNDAMENTALS: The drama is building, but the outcome is still a mystery to the vast majority of Americans. Last week President Johnson announced that the Federal Budget for the year ending June 30, 1967, will be around $127 billion. This represents an increase of 25% over the June, 1965 budget. The reason for the whopping increase can be summed up in two phrases, Vietnam and rising interest costs. The President announced that he would ask for a $10 billion "supplemental" to cover the extra cost of the Vietnam war. The total 1967 Federal budget is to be $127 billion while total income is estimated to be $117 billion. The President did not say how he would raise the extra $10 billion, but a tax increase was included as a distinct possibility.

NOTES & QUOTES: Mr. Hamilton Bolton has just sent me (and the rest of his readers) a 40-page transcript of the 4th annual "Contrary Opinion" Forum, which is set up by Humphrey Neill and Jim Fraser. I would have liked to have been there, but San Diego is too nice to leave this time of the year (or any other?) At any rate, I read the whole 40 pages carefully, and they contained a mountain of information.

Two sections, for some reasons, struck me as outstandingly informative. The first by Bolton. himself, in response to a question about the private and public sector of the economy in fomenting recessions: MR. BOLTON: "These gentlemen have said almost everything there is to tell. I would like to refer you to my chart called 'The Economy and the Stock Market'. It seems to me in looking at the various charts we have here that we are placing more importance on the government side of the thing than is warranted. I think that the culprit in this little affair is not the fact that we got ourselves into the Vietnam situation, which has been costly and has increased government expenditures $5, $10, $15, $20 billion, you name it. The private sector is the culprit. I think the private sector is the area where fiscal and monetary policy is least effective. If you take a simple measure of capital expenditures, let's say, compared to manufacturers' sales or final sales on your GNP, which is your GNP less inventory investment, you will find that the degree of capital expenditures in this rise from 1961 to 1965 or 1966 is far in excess of the last capital boom which terminated in 1957. Now you just get to a point in the private sector where this thing is unsustainable. This will not show up in the sales-inventory ratio because sales are going up too. Therefore, when people talk about the sales-investory ratio being sound because it hasn't changed very much in the last few months, this is typical of a boom period. At the end of a boom period it rarely does change and people should go back and look at these statistics instead of simply saying 'now the sales-inventory ratio is no worse than it was last year or the year before, therefore everything is all right'.

"My own feeling is that this is the first time in the postwar period that the private sector can take over and control the economy. I think what we are seeing today, in automobile sales, is a personal disposition of the consumer. You can't control it and I don't care what the government does about fiscal policy. I don't think there is anything in the fiscal or monetary picture which made consumers say in May of this year that they were not going to buy automobiles any more or they were going to buy them only on sale. Does any fiscal or monetary action on the part of the government make consumers turn around? We have evidence that it doesn't in such recessions as 1937, for instance. We don't have to go back to 1931 or 1932 to find that you just can't tell. In other words, you have no way of knowing in advance how people are going to react."

And this fascinating pair of paragraphs from Mr. Maurice Kingsley, developer of the Computrend service: "There is nothing mysterious about a computer. All the computer will do is add, multiply, subtract and divide and everything therein. It can do only what the people want to know, what problems they would like to find; and they delegate and outline these problems to people who are called 'programmers'. Programmer people confer the thoughts, ideas and questions into instructions which they program in a certain way so that the machine will respond. For example, they may want to know, what is the percentage change of stocks over fifteen weeks for every week of the year. The programmer will take the ideas and he will convert them and give you the results. When the results come back you can look at the results and you can ask, is there something interesting?

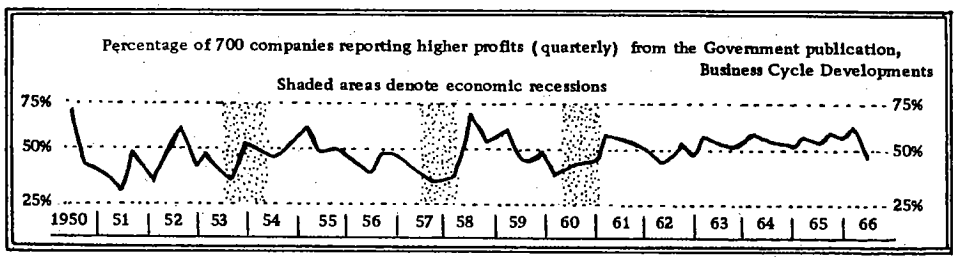
"The first and most obvious thing about programs and computers in the stock market is that a man will come up to you and say he has a little black box and it really works and he has spent an enormous amount of time and perhaps even capital to find this wonderful, great thing - it really works. He's got it down real pat. There is only one problem; the market is a thing that changes consistently and by the time he has spent three or five years figuring out the wonderful method the market is a completely different entity, and as a result that program will not work and it has been tedious to find out; he loses his capital and he is back where he started from. Now I stress that because a lot of people have come to Wall Street with ideas. I have seen so much come across my desk. Anything that anyone would ever develop, I promise you, will not work, whether it is for six months, a year or two years, because the market is changing. As a matter of fact, in the last six years, the rate of change in the market is increasing and I want to mention this in a few minutes."

It is obvious that President Johnson has refused to confront the American people with anything like honesty regarding the national budget. While projections of income and outgo for 1967 look bleak, he prefers to talk about "anti-inflation taxes," and other methods of keeping the economy from boiling. The shock of recognitions, when it arrives, is going to stir the American people into a fury, and already the latest (Harris) poll shows President Johnson's popularity dropping to a new low. Only 43% of those polled believe the President is doing a good job.

But in this writer's opinion, the real fireworks will come in mid-1967, when it becomes apparent that corporate receipts are far below expectations, and when it becomes clear that the nation faces one of the biggest budget deficits in history. I believe that instead of the $10 billion supplemental which is to be asked for, by mid-1967 (the fiscal year ends on June 30, 1967) the deficit is likely to be 2 to 3 times that amount.

Why do I say that corporate profits (and consequently Government tax receipts) are going to drop in 1967? The fact is that the market is saying it for me. I have just reviewed charts of all the major industrial groups, and here is what I see. The following groups have "topped out," and I believe they are all in long-term primary downtrend: Autos, Chemicals, Electronics and Electrical Equipment, Farm Equipment, Finance, Food Chains, Rails and Rail Equipment, Retail Stores, Steels, Textiles. There is no question about it as far as I am concerned. These groups read like a "Who's Who" of the American economy. All of them heading down together is spelling trouble for sales and profits, trouble for the American economy.

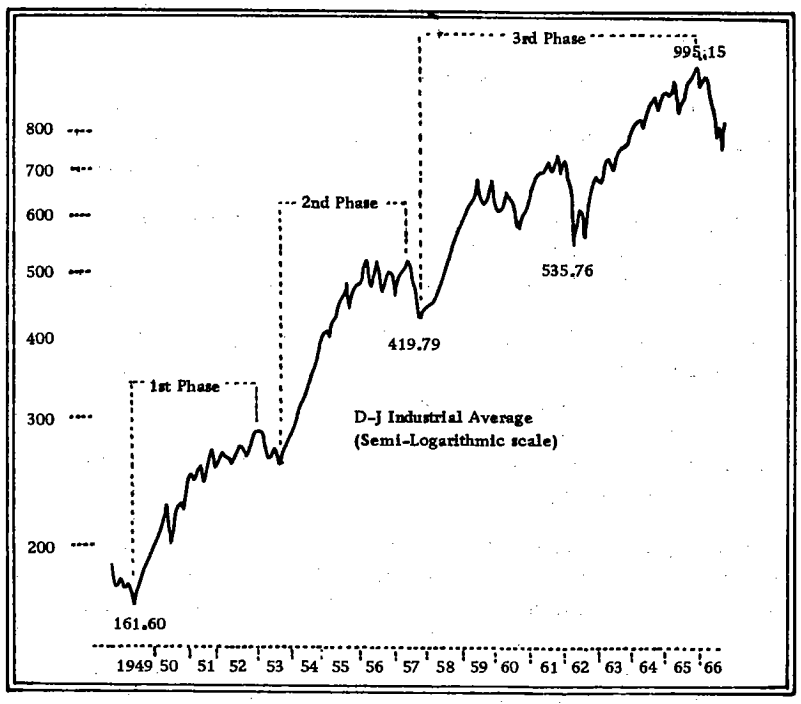
As a further suggestion of shrinking corporate profits, I have redrawn a chart from BCD showing the percentage of 700 corporations announcing a quarterly increase in profits. Note that for the first time since 1962 the percentage is now less than 50%, not a good omen for the 1967 profit picture.


Percentage of 700 companies reporting higher profits (quarterly) from the Government publication, Business Cycle Developments
Shaded areas denote economic recessions
75%
50%
25%
1950 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66

By mid-1967 the Administration is going to have to face the fact that the nation is running out of money--with corporate tax receipts falling far short of expectations. A recession will probably be in progress, and Congress will not want to raise taxes. The only alternative is going to be the money market. The Treasury is going to have to turn to debt financing--heavy debt financing. And that is why the "sophisticated money" which trades in bonds has just driven the D-J 40-Bond Average (see last Letter) down to its lowest level in 33 years. The bond market is quietly backing off to lower level, preparing for the chaos in the money markets which lies ahead.

Therefore, I see all the present action as (1) a pause or "breather" in the economy, with plenty of trouble to come in 1967. At that time it would not surprise me to see massive Government financing and a new round of interest rate boosts that could well go above the peak rates of 1966. (2) I see the current action in the stock market as a "technical breather" preparatory to the next major downward leg of the bear market. I believe that those who buy here are going to regret it within a matter of months, and I would guess that by the end of the 1st quarter of 1967 this primary bear market will be smashing to new lows. The market will tell its story in its own good time. Impatience during a bear market has ruined many an investor.

BIG PICTURE: I have drawn a chart (ratio or semi-log scale, showing percentages) which traces the progress of the D-J Industrial Average from 1949 to date. The late great bull market started in June, 1949, at 161.60 on the Dow. The first psychological phase of the bull market (see chart) carried to early 1953. This is the phase wherein stocks rebound from the depressed psychology of the preceding bear market. In the first phase yields are high, stock values are great, and the public is notably disinterested. It is the true investor who does the buying during the first phase of a new primary bull market.



Following the 1953-54 reaction, the second phase of the bull market began. This is the rather dramatic phase in which stocks go up in obvious response to improving business conditions. Volume on the Exchange increases as the public begins to take an active interest in the market. The second phase was terminated by a particularly confusing and deceptive secondary reaction, lasting from 1956 until late-1957. The "Sputnik" crisis proved to be the news event which finally "shook" the market down to its October, 1957 secondary lows.

The third psychological phase began in 1958. This is the speculative phase, characterized by broad public participation, speculation, rumor-buying, "hot tips," heavy volume, and a new-found belief on the part of the little investor that Wall Street will provide the answer to his dream of "riches, success and security." The 1958-1966 third phase was the only one in history which, in duration, surpassed the preceding bull market's second phase. The 1958-66 third phase was also deceptive (and unique) in that it was divided into three distinct parts, 1958 to 1960, 1960 to 1962, and 1962 to 1966. Each of these periods was market by its own brand of speculation, and each ended with a secondary correction. In mid-1958 the average yield on the Dow slipped into the rarefied 3% zone; it remained in that area of high-valuation for the next 8 years. During that entire 8-year period, average bond yields surpassed average stock yields, and in many cases the bonds of a given company provided a higher yield than the common stock of the same company. The nation had taken the inflation thesis completely to heart--common stocks were the key to safety and success.

Wall Street, however provides its own brand of irony. On February 9, at 995.15 on the Dow, the great bull market ended. It ended after 17 years of generally rising prices, during which time the Dow advanced 521%. In the next 8 months the Dow headed down, and by October the Industrial Average had succeeded in wiping out 30% of all the gains recorded since the bull market began in 1949. Investors were confused--but undaunted. As of this writing, many believe that the bear market ended in October, while

 perhaps the majority are convinced that we have witnessed "1962 all over again." I have been warning my subscribers against accepting this thesis. I have been telling new readers to take their profits, to accept their losses, but above all to move out of the stock market and into a protected cash position. I believe that we face a long, drawn-out primary bear market, one that could last two or three years, and one that could take the Dow substantially lower.

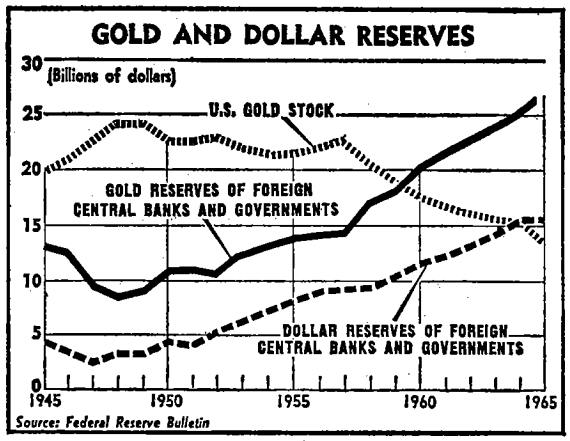
One question we are all wondering is this: Logically, how far can we expect the bear market to carry on the downside before the primary bear trend is exhausted? I have been giving this matter a great deal of thought, and I have examined the situation from many standpoints. First I want to say this--I have absolutely no faith in the multitudinous projections and predictions regarding "next year's earnings." I have seen economists, analysts, and corporate officers too wrong too often to swallow their predictions of what is supposed to be "next year." Without "crystal ball knowledge" of next year's investor and consumer psychology, it is absolutely ridiculous to attempt to figure what the 1967 earnings picture is going to be. Will consumers cut back in their spending, will corporate outlays be up or down, will inventories be increased or slashed? There are far too many imponderables to consider, and I have learned the hard way that I cannot take Wall Street's or anybody else's estimates of next year's earnings seriously.

My only guess is that this being a primary bear market, there are going to be more troubles, more problems (and earnings are likely to be lower in 1967) than anyone envisions at this time. During a bear market events have a way of "not working out as expected," and as one set of factors reacts adversely on the economy, another set of factors is set into motion. The net result is apt to be troubles, unexpected difficulties, and a general contraction of sales and earnings in all sectors of the nation.

Therefore, I am going to eliminate fundamental considerations in my attempt to estimate how far this bear market could go on the downside. I am going to use technical and "common sense" factors. Study the accompanying chart on page 3. First, I would expect this bear market ultimately to erase all the gains of the preceding bull market's third phase. In other words, I would expect the bear market to correct at least all of the gains since the 419.79 low of 1957. This, in my opinion, would take the Industrial Average back to "basic value" in the light of past stock market history. But in a bear market, I would expect stocks to go below known values; this is what occurs during the third or final phase of a primary bear market. Therefore, it would not surprise me if the Dow (during its final third phase bear market decline) were to sink into the 350 to 400 area. This would undoubtedly represent the area of "under-valuation," and it would correspond to the depressed levels which I would expect to see during the final stages of this bear market.

In other words, before this primary bear market is over, I expect to see all the gains of the 1958-66 bull market third phase wiped out, and I expect to see the Dow sink into the area of the second phase (255 to 520) of the 1949-66 bull market. My guess is that the current bear market will terminate nearer the 255 (1953 bottom) area than the 520 (1956 top) area. Time alone will tell the story.

NOTES: The latest Federal Reserve gold ratio shows a drop to a new low of 31.8%. Despite the widely heralded announcement that France has ceased drawing on U.S. Gold, we lost another $100 million on gold a few weeks ago. The chart at right from the New York Times tells the dramatic story, and the trends are clear enough. It would now seem a question of "who is going to pull the plug and when."



Meanwhile, new problems arise for the pound in the wake of the Rhodesian crisis. Britain wants "selected" sanctions against Rhodesia, other African states want war against Rhodesia (Britain or the UN is to do the fighting), and Prime Minister Smith of Rhodesia hints that he may want to talk to Wilson a bit more before settling back to weather the sanctions. But one thing is sure, sanctions against Rhodesia will hurt the pound, and if South Africa should be drawn into the fray, the pound would fall (S. Africa is Britains fourth biggest market).

What bothers the African nations is the historical fact that sanctions don't work. The odds on sanctions bringing Rhodesia to its knees are slim indeed. Furthermore, the U.S. is probably a bit queasy about the whole idea of getting into the African picture. After all, when you've produced something like the Vietnam tragedy, you (and I mean President Johnson) think twice before jumping in on what could be another cosmic goof.

Speaking of the President, it appears that the big question of 1967 and 1968 is going to be this, "Will LBJ run again?" If you think that a Johnson ticket is in the bag for 1968 the rumor mill is saying "think again." Obviously someone knows something, and that something adds up to the fact that Johnson's popularity is collapsing, he is becoming upset and depressed about this, and any further series of adverse events could bring on serious doubts about his running. My prediction as to the "adverse events" for 1967: Johnson is through with Congress; he is not going to get anywhere with Congress in 1967. As my friend Eliot Janeway says, when the Executive and the Legislative branches are at odds--watch out. It bodes trouble for everyone including Wall Street.